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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1938.

No. 65.

DOUGLAS FAIRBANKS,
*Petitioner,*

*against*

UNITED STATES OF AMERICA,
*Respondent.*

On Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

# BRIEF FOR PETITIONER

ARTHUR F. DRISCOLL,
*Counsel for Petitioner.*

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### Opinions Below.

The opinion of the District Court is not officially reported, but is printed in full at pages 51-55 of the Record.

The opinion of the United States Circuit Court of Appeals for the Ninth Circuit is reported in 95 F. (2d) 794 and appears at R. 132-138.

### Jurisdiction.

The judgment of the Circuit Court of Appeals was entered April 2, 1938 (R. 139). A petition for writ of certiorari was denied by this Court on October 10, 1938 (83 L. Ed. 13).

A motion for leave to file a petition for rehearing was granted by this Court and the order denying certiorari was vacated and the petition for writ of certiorari granted on January 16, 1939 (83 L. Ed. 339).

The jurisdiction of this Court is invoked under the sections of 240(a) of the Judicial Code, as amended by the Act of February 13, 1925 (Chap. 229, 43 Stat. 938).

## Questions Presented.

No question of fact was presented below. All facts are set forth in the pleadings and special findings (R. 59-74).

The specific questions at issue are:

> (1) Does the redemption before maturity of bonds by the issuing corporation constitute *a sale or exchange of capital assets* within the meaning of Section 208(a)(1) of the Revenue Act of 1926, and Section 101(c)(1) of the Revenue Act of 1928? Or
>
> (2) Is the gain realized by the bondholder from the redemption of bonds before maturity to be taxed at the 12½% rate or at normal and surtax rates?

Other questions considered by the Circuit Court of Appeals are not herein involved.

## Statement of the Case.

### The Bonds and Their Issue.

Prior to March 5, 1925, the taxpayer was the owner of eight finished and one unfinished motion pictures (F. V, R. 60). On that date he transferred the said pictures and all rights thereto, together with certain other property, to

(NOTE: The abbreviation "F." is used to indicate "Findings of Fact" and "R." to indicate "Record.")

The Elton Corporation, in exchange for $4,000,000 face value debenture bonds of said corporation and 990 shares of its stock (F. VI, R. 60). The debentures matured March 5, 1935.

The debentures contained the following provision:

> "This debenture bond may be redeemed by the corporation at any time at its face value plus interest earned and unpaid hereon upon thirty days' notice to registered holder hereof" (F. VII, R. 60).

At the same time the taxpayer entered into a contract with The Elton Corporation containing a provision under which the corporation obligated itself to redeem $100,000 face value of the bonds per year beginning three years after date of the contract, that is, after March 5, 1925 (F. VII, R. 60).

**Redemptions During 1927, 1928 and 1929.**

The Elton Corporation redeemed, and the taxpayer surrendered for redemption, $1,600,000 face value of the debentures in 1927 (F. VIII, R. 60), $150,000 face value in 1928 (F. IX, R. 61), and $150,000 face value in 1929 (F. X, R. 61).

**Taxpayer Filed Returns for 1927, 1928 and 1929.**

The taxpayer duly filed his income tax returns for the years 1927, 1928 and 1929, and reported therein the sums received from the redemption of said bonds. He paid a tax on the profits from the redemption of said bonds shown in said returns at the rate of 12½% (Fs. XIV, XV and XVI, R. 62; Fs. XVII and XVIII, R. 63; Fs. XXII and XXIII, R. 65).

**Controversy as to 1917-1926, Settled in 1929.**

At the same time—that is, during the years 1927, 1928 and 1929—the taxpayer still had before the Commissioner of Internal Revenue a controversy as to taxes for the years 1917 to 1926, involving the question of whether or not the cost of

motion pictures could properly be deducted as expenses in the year in which expended, as had theretofore been customary (F. XVI, R. 62).

In December, 1929, a settlement was reached with the Commissioner of Internal Revenue as to taxes for the years 1917 to 1926 (F. XIX, R. 64). The settlement involved a recomputation of the taxes for those years, changing the method that had been used by the taxpayer whereby the taxpayer expensed the cost of the pictures in the year when made, to a basis of capitalizing the cost of pictures and amortizing the cost over a period of four years after the release of each picture; that is, 75% in the first year, 15% in the second year, 5% in the third year, and 5% in the fouth year (F. XX, R. 64).

The recomputation and amortization of the cost in accordance with the aforesaid formula required the taxpayer to pay, and the taxpayer did pay, additional taxes and interest for the years 1917 to 1926 in the sum of $695,840.53 (F. XXI, R. 64).

**Unamortized Cost as of End of 1926.**

According to the aforesaid settlement and recomputation, it was determined that the taxpayer still had an unamortized cost of pictures as of December 31, 1926, of $1,096,445.52, a proportionate part of which he was entitled to deduct from the proceeds of the bonds redeemed during each of the following years (F. XXI, R. 64).

The taxpayer had already filed his tax returns for 1927 and 1928, prior to the aforesaid settlement, reporting the entire proceeds of the bonds redeemed in those years as taxable, and deducting nothing for cost (F. XV, R. 62; F. XVIII, R. 63), and for 1929 (the return for which was filed after the settlement was arrived at, but before unamortized cost was definitely fixed), the taxpayer had deducted against the proceeds of the bonds a proportionate part of an estimated unamortized cost as of December 31, 1926, of $928,-630.87, instead of the official figure of $1,096,445.52, later definitely fixed (F. XXII, R. 65).

On August 7, 1930, one L. E. Fellers, an Internal Revenue agent, made a report of his audit of the income tax returns filed by the taxpayer for the years 1927, 1928 and 1929, and officially fixed the unamortized basic cost of the bonds as of December 31, 1926, at $1,096,445.52 (instead of the estimated $928,630.87) and treated the profit received by the taxpayer from the redemption of said bonds during said years as capital net gain taxable at 12½% (Fs. XXIV and XXV, R. 66).

Following the report of Revenue Agent Fellers, the taxpayer filed with the Commissioner of Internal Revenue claims for refunds for the years 1927, 1928 and 1929, setting forth therein that he had not deducted from the proceeds of the bonds redeemed in the years 1927 and 1928 any part of the basic cost, and for 1929 had deducted a proportionate part of $928,630.87 instead of the official figure of $1,096,-445.52 (Fs. XXVI-XXXII, R. 66-71).

The Commissioner of Internal Revenue recomputed the taxes on the profits made from the redemption of the said bonds, at the basic rate of 12½%, and determined that the taxpayer was entitled to refunds and he did refund to the taxpayer for the year 1927 the sum of $53,231.55, together with interest in the sum of $9,795.04; for the year 1928, $7,507.38, together with interest in the sum of $932.40; for the year 1929, $677.57, together with interest in the sum of $42.99 (Fs. XXXIII and XXXV, R. 71, 72).

Later, however, the Commissioner of Internal Revenue changed his ruling and determined that the refunds were erroneous, claiming the redemption of the bonds did *not* constitute *the sale or exchange of capital assets,* and therefore the profits were not taxable at the rate of 12½%, but were taxable at the higher (normal and surtax) rates applicable to other income of the taxpayer for the years in question, and he demanded the return to the Government of the sums refunded (F. XXXVI, R. 73). The taxpayer refused to return the refunds.

Action was begun therefor in the United States District Court for the Southern District of California, Central Division. After trial (jury waived), judgment was rendered in favor of the Government (Judgment, R. 76). The Circuit Court of Appeals affirmed that part of the judgment.

## Specification of Errors.

Petitioner respectfully urges that the Circuit Court of Appeals for the Ninth Circuit erred:

1. In ruling that the redemption by The Elton Corporation of its bonds during 1927, 1928 and 1929 was not a "sale or exchange" of capital assets by taxpayer within the meaning of the Revenue Acts of 1926 and 1928.

2. In ruling that the taxpayer must pay income tax on the gain from said redemption at normal and surtax rates instead of at the $12\frac{1}{2}\%$ tax rate on capital gains as provided in the Revenue Acts of 1926 and 1928.

3. In ruling that the refunds made to the taxpayer on January 26, 1932, by the Commissioner of Internal Revenue were erroneous and that the United States was entitled to recover the amounts of said refunds with 6% interest thereon from the date of their payment.

4. In not ruling that the taxpayer had overpaid his Federal income taxes for the years 1927, 1928 and 1929.

## Summary of Argument.

The redemption of bonds constitutes "sale or exchange" within the meaning of Section 208-a-1 of the Revenue Act of 1926 and Section 101-c-1 of the Revenue Act of 1928.

A. The statute involved and its requisites.

B. There have been shifting and conflicting decisions as to whether redemption of bonds comes within the term "sale or exchange."

C. It was *not* the intention of Congress to exclude redemption of bonds from the benefits of the capital gains section.

1. The meaning of the words "sale or exchange."
2. What is a redemption?
3. The exclusion of bond redemption from the benefits of the capital gains statute produces inequitable and absurd results.

D. The interpretation of the word "exchange" added to the capital gains section by Congress in 1934 constitutes a legislative declaration of its meaning and governs the construction of the capital gains provision from the time of its first enactment in 1921.

E. Conclusion.

1. The surrender by the taxpayer of bonds of the Elton Corporation for redemption during the years 1927, 1928 and 1929 was an exchange or sale of capital assets within the meaning of the provisions of the Revenue Acts of 1926 and 1928, and the excess of the sum received by the taxpayer over and above cost basis to the taxpayer was capital gain within the meaning of the Revenue Acts of 1926 and 1928 and was taxable to him at the flat rate of 12½% instead of at the higher rates (normal and surtaxes).
2. The judgment of the Circuit Court of Appeals for the Ninth Circuit and the judgment of the District Court for the Southern District of California, Central Division, should be reversed and the complaint dismissed.

## The Redemption of Bonds Constitutes "a Sale or Exchange" Within the Meaning of Section 208-a-1 of the Revenue Act of 1926, and Section 101-c-1 of the Revenue Act of 1928.

### A.

### The Statute Involved and Its Requisites.

Section 208-a-1 and a-8 of the Revenue Act of 1926 (44 Stat. 19) and Section 101-c-1 and c-8 of the Revenue Act of 1928 (45 Stat. 811) are identical, providing:

> "'Capital Gains' means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921.
> 'Capital Assets' means property held by the taxpayer for more than two years * * *."

Compliance must be had with three conditions:

(1) It must be a capital asset.

(2) Held for two years or more.

(3) The gain must have resulted from a *sale or exchange.*

It is beyond dispute that (1) the bonds of The Elton Corporation constituted a capital asset and (2) had been held by the taxpayer for more than two years.

The sole question is whether the redemption of bonds (before maturity) constituted a "sale or exchange."

### B.

**There have been shifting and conflicting decisions as to whether redemption of bonds comes within the term "sale or exchange."**

In IT 1637, II, 1 C. B. 36 (1923) (Appendix A), the Commissioner of Internal Revenue ruled that the payment of a non-interest bearing municipal bond at maturity did not constitute a "sale or exchange."

This ruling would seem to be limited to its own particular facts, for G. C. M. 1455, VI, 1 C. B. 87 (1927), holds that capital gain or loss is recognized on the sale or redemption of bonds, stating at page 89:

> "The final position taken made no change in the rule as to original purchasers but reverted to the position first taken in so far as taxpayers who were not original purchasers were concerned. Thus, I. T. 1637 (C. B. II-1, 36) holds that where non-interest-bearing municipal bonds were issued at a discount, the profit realized upon payment at maturity by a holder who was not the original purchaser was taxable. The prevailing rule as to holders other than original purchasers—and that is the classification which includes the banks in the instant case—is that discount (and by analogy premium) is not to be treated as interest (or as an offset against interest in the case of premium) whether the bonds are sold or held to maturity. *The amount for which the bonds are purchased without regard to any discount or premium element therein is to be taken as the basis for determining gain or loss on their sale or redemption (O. D. 726, C. B. 3, 49), any profit realized being a profit resulting from the conversion of a capital asset and any loss sustained being deductible."* (Italics ours.)

There seems to be no logical reason for a distinction between redemption *before* maturity and redemption *at* maturity. It is not clear that the Commissioner intended any.

In *Henry P. Werner,* 15 B. T. A. 482 (1929), the Board of Tax Appeals unanimously decided that the redemption of bonds *prior to maturity* did constitute a "sale or exchange." *The Commissioner acquiesced in this decision* and issued a new ruling revoking IT 1637, *supra.* The new ruling, IT 2488 VIII-2 C. B. 127 (1929) (Appendix B), definitely included both redemptions before maturity and redemption at maturity and ruled that such redemption did constitute "sale or exchange."

The Board followed the *Werner* decision in *Alpin W. Cameron,* 20 B. T. A. 305 (July 22, 1930), aff'd 56 F. (2d) 1021.

On December 29, 1932, the Board unanimously reversed itself in the case of *John H. Watson, Jr.*, 27 B. T. A. 463. The Board ruled that the redemption of a bond *at maturity* was *not* a "sale or exchange," and stated that the same ruling applied to the redemption of bonds *prior to maturity,* directly overruling the *Werner* decision. The Commissioner again acquiesced and followed by promulgating IT 2678 XII-1 C. B. 117 (1933) (Appendix C), which revoked IT 2488, *supra*, in so far as it applied to bonds.

The final steps in the conflicting interpretations of "sale or exchange" are the decision of the Ninth Circuit Court of Appeals presently being reviewed herein holding that the redemption of bonds is not a "sale or exchange" (Apr. 2, 1938), and the decision in *Frances M. Averill* v. *Commissioner* (Dec. 28, 1938) of the First Circuit Court of Appeals (Appendix D), holding that redemption of bonds is a "sale or exchange."

## C.

**It was *not* the intention of Congress to exclude a redemption of bonds from the benefits of the capital gains section.**

First of the Revenue Acts according special treatment to capital gains was the Revenue Act of 1921, which permitted taxpayers to elect a flat tax of 12½% on gains from the "sale or exchange" of capital assets, in lieu of the normal and surtaxes formerly applicable.

When the Revenue Act of 1921 was being drafted, it was recognized that large amounts of revenue were lost by reason of the fact that taxpayers were reluctant to realize profits from capital investments because under the existing law such profits were allocable to the year of realization, and were thus subject to extremely high surtaxes. Such gains, unlike other income, might have accrued over several years, and the taxation of profits in the particular year in which they were realized, at a progressive rate, was imposing an undue and excessive tax burden. In order to give relief to the taxpayer and to permit such transactions to go forward, the Revenue Act of 1921 provided for the flat tax.

The Supreme Court has recognized these purposes of Congress in *Burnet* v. *Harmel,* 287 U. S. 103 (1932), where Mr. Justice Stone said, at page 106:

> "* * * The provisions of the 1921 Revenue Act for taxing capital gains at a lower rate, re-enacted in 1924 without material change, were adopted *to relieve the taxpayer from these excessive tax burdens on gains resultant from a conversion of capital investments and to remove the deterrent effect of those burdens on such conversions.*" (Italics ours.)

Mr. Justice Roberts in *Helvering* v. *New York Trust Co.,* 292 U. S., at page 470, speaks of "the paramount purpose to permit the payment of tax on capital gains at a reduced rate."

"Capital assets" as defined by the capital gain and loss provisions of the Revenue Act are "property held and acquired by the taxpayer for *profit and investment* * * *."

Corporate bonds and debentures are surely one of the most favored forms of capital investment, as financial history shows, and examinations of portfolios of banks, insurance companies and other professional investing companies disclose. Every bond has a maturity date and many are subject to redemption on call.

The *New York Times* of February 1, 1939, page 34, stated that bond redemptions before maturity *during January, 1939,* amounted to $249,912,000. Surely Congress was cognizant of the nature of bonds and their common use as a medium of capital investment at the time of the insertion of the capital gain and loss provisions in the Revenue Act of 1921.

Having in mind that the purposes of the change were (a) to relieve the taxpayer from excessive tax burdens, and (b) thereby to remove a deterrent to the conversion of capital assets, and remembering that bonds are one of the most familiar forms of capital assets and investments, let us examine the words "sale or exchange" to determine if there is any good reason why a redemption of bonds should be excluded therefrom.

1.

THE MEANING OF THE WORDS "SALE OR EXCHANGE."

> " 'Sale or exchange' is a transmutation of property from one man to another in consideration of some price or recompense in value."

2 Blackstone's Commentaries, p. 446.

*Baltimore & Ohio Railroad Co.* v. *Western Union Telegraph Co.*, 241 Fed. 162-170, aff'd 242 Fed. 914 (1917).

The legislative history of the capital gain and loss provisions shows no intention on the part of Congress to narrow this definition.

The Ways and Means Committee of the House of Representatives in reporting the Revenue Act of 1921 (No. 350, Sixty-seventh Congress, First Session, to accompany H. R. 8245) said

> "In order to permit such transactions to go forward without fear of a prohibitive tax, the proposed bill, *in Section 206*, adds a new section (207) to the income tax, providing that where the net gain from the *sale or other disposition of capital assets* would, under the ordinary procedure, be subjected to an income tax in excess of 15%, the tax upon the capital net gain shall be limited to that rate." (Italics ours.)

It is to be noted that the report uses the all-inclusive terms of "sale or other disposition."

The bill referred to by the House reads as follows:

> "The term 'capital gain' means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921.
>
> * * * * * *
>
> The term 'capital assets' as used in this section includes property acquired and held by the taxpayer for *profit or investment* (whether or not connected with his trade or business) but does not include prop-

> erty held for the personal use or consumption of the taxpayer or his family, or stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year." (Italics ours.)

The distinction there made was between transactions for profit and other transactions. It is apparent that there was no intention to further subdivide transactions for profit between voluntary transactions on the one hand and involuntary transactions on the other.

In Report No. 275 of the Senate Committee on Finance (Sixty-seventh Congress, First Session), to accompany H. R. 8245, the same bill, the Committee states:

> "In order to permit such transactions to take place without fear of prohibitive tax, *Section 206* provides that only 40% of the net gain derived from the *sale or other disposition of capital assets* shall be taken into account in determining the net income upon which the income tax is imposed." (Italics ours.)

The Senate made no changes in the words "sale or exchange" contained in the House Bill.

It seems clear, beyond peradventure, that both the Senate and the House intended the words "sale or exchange" to mean any disposition of a capital asset held for profit or investment, by which title to the capital asset changed hands, for a valid consideration and on which gain or loss might be recognized. Congress sought words that would achieve that purpose and describe such transactions in contra-distinction to a gift, devise, bequest or other change of title needing special treatment. This is clearly brought out by reference to other sections of the Revenue Act of 1921. To describe transactions concerning capital assets on which gain or loss might be recognized Congress used the words "sale or exchange." But Congress in Section 202(a) uses the words "sale or other disposition." Why not in Section 206?

Section 202(a) of the Revenue Act of 1921 sets forth the basis for determining gain or loss *upon any transfer of property.* In this section Congress had to take cognizance of the fact that transfers of property take place both with and without consideration. Therefore, in enacting said section, Congress advisedly used the words "sale or other disposition" as it had in the 1913 and every succeeding Revenue Act.

Congress then goes on in further subdivisions of Section 202 to prescribe cost basis for property received by sale, exchange, gift, devise, bequest, reorganizations, condemnations, theft, seizure or destruction.

The conclusion seems irresistible that Congress, in enacting *the capital gains and loss provisions,* intended to include all transfers of title of capital assets held for profit and investment on which a gain or loss would be realized (sales or exchanges).

Yet the Board of Tax Appeals and the Ninth Circuit Court of Appeals excluded bond redemptions from the above all-inclusive words and intention.

As Circuit Court Judge Mathews, in his opinion in the instant case, states (R. 136):

> "Defendant cites Report No. 350 of the House Ways and Means Committee and Report No. 275 of the Senate Finance Committee, accompanying the Revenue Bill of 1921, as indicating a purpose to include in this definition gains resulting from the redemption of capital assets. We find in these reports no indication of any such purpose."

The learned Judge refuses to agree that the most logical explanation for the use of the terms "sale or exchange" was an intention to include all transactions where title to property was transferred in exchange for cash or other property and to exclude gifts and "other dispositions."

2.

## What Is a Redemption.

The word "redemption" has a meaning of general legal application, which is in no way limited by the Revenue Act.

In *Words and Phrases* (2nd Series), Vol. IV, page 220, the following is stated:

> " 'To redeem' is defined as to purchase back; to regain property by paying a stipulated price; to regain property by paying what is due; to receive back by paying what is due; to receive back by paying the obligation * * *.
>
> The word 'Redeem' does not mean to buy: it means to buy back; to liberate an estate by paying the debt for which it stood as security; to purchase in a literal sense."

In *Mannington* v. *Hocking Valley Ry. Co.*, 183 Fed. 133 (1910), the Court said:

> " 'To redeem,' it is said in Miller v. Ratterman, supra, 'is to purchase back; to regain by paying what is due; to receive back by paying the obligation.' The word 'redeem,' as used in statutory provisions authorizing a party to redeem, means 'repurchase.' *Robinson* v. *Cropsey,* (N. Y.) 2 Edw. Ch. 138, 146; *Pace* v. *Bartles,* 47 N. J. Eq. (2 Dick.) 170, 20 Atl. 352."

The word "redeem" is similarly defined in Webster's International Dictionary, where the first definition given is as follows:

> "To regain possession of by payment of a stipulated price; to repurchase."

See also:

> *Bunn* v. *Braswell,* 142 N. C. 113, 116; 55 S. E. 85.
>
> *Miller* v. *Ratterman,* 47 Ohio St. 141, 156; 24 N. W. 496.
>
> *Swearingen* v. *Roberts,* 12 Neb. 333, 335; 11 N. W. 325.
>
> *Pace* v. *Bartles,* 47 N. J. Eq. 170, 174; 20 Atl. 352.

We can find no distinction drawn between redemption before maturity date and redemption at maturity date in so far as definition is concerned.

Redemption before maturity date is merely the very frequent expedient of accelerating the maturity, usually at the option of the issuing corporation.

Whether his bonds are called for redemption or sold in the open market, the bondholder is parting with a capital asset in exchange for money.

To attribute to Congress an intention to exclude redemption of bonds from the benefit of the capital gains provision is to disregard the plain meaning of the words "sale or exchange" and to produce absurd and inequitable differentiation between taxpayers similarly situated.

What is there concerning bond redemptions that should exclude them from the beneficial applications of the capital gains provision?

3.

THE EXCLUSION OF BOND REDEMPTION FROM THE BENEFITS OF THE CAPITAL GAIN STATUTE PRODUCES INEQUITABLE AND ABSURD RESULTS.

The bond market being subject to fluctuation, it seems apparent that on few bond redemptions will gain or loss not occur. To attribute to Congress an intent to exclude bond redemptions (at maturity or before maturity on call) from the benefits of the capital gain and loss section, while allowing such benefits where bonds are *purchased in the open market,* produces an absurd and inequitable result.

The unreasonableness and injustice of the exclusion of bond redemptions from the benefits of the capital gain section and the penalization effected thereby is clearly shown (a) by those cases that deal with the *redemption* of preferred stock and (b) sales of bonds held for more than two years even immediately before maturity of bonds, and (c) the treatment accorded gains on other "forced" sales.

a.

The Board of Tax Appeals ruled in *Mary S. Childs* v. *Commissioner,* 35 B. T. A. 1125 (1937), that the calling in of preferred stock by the issuing corporation constituted a "sale or exchange of capital assets."

See also:

> *Robert Meyer,* 27 B. T. A. 44 (1932).
> *Louis Rorimer,* 27 B. T. A. 871 (1932).

It is difficult to recognize either a real or practical distinction between the redemption of preferred stock and the redemption of bonds when each is the result of demand or notice by the corporation.

b.

The Board of Tax Appeals made a similar ruling in the case of *John D. McKee, Trustee, et al.* v. *Commissioner,* 35 B. T. A. 239 (1937). In that case the taxpayer had bonds which had been called for redemption at the American Trust Company on Monday, February 2, 1931. On Saturday, January 31, 1931, the taxpayer sought to *sell* the bonds to the corporate trustee at the office at which the bonds were payable. The trust officer informed the taxpaper that the corporate trustee had no right to purchase the bonds but referred him to the security affiliate of the trustee. Thereupon Mr. McKee detached the coupons and sold the bonds at par to the security affiliate of the corporate trustee, who in turn, on Monday, February 2, 1931, presented them to the corporate trustee and received payment in full.

It was specifically found as a fact that the only reason for the sale of the bonds by the taxpayer to the security affiliate was to place the transaction within the capital gains provisions thereby to avoid being taxed at a higher rate. The Board of Tax Appeals by unanimous decision held the transaction to be valid and the taxpayer to be entitled to the benefits of the capital gains section.

It seems unjust and inequitable that friendly sales could have been arranged by the taxpayer in the case at bar one day before the due date of the calls for redemption, with a difference in income taxes amounting to $165,156.67.

c.

The revenue statutes do not deny a taxpayer the benefits of the capital gains provisions when a corporation is liquidated. A minority stockholder may very well have voted against a liquidation but have been forced to accept it. No distinction could legitimately be made for tax purposes between stockholders voting to dissolve and those objecting thereto.

And as shown *supra*, capital gain or loss must be computed by a preferred stockholder whose stock is redeemed upon call by the corporation.

Neither does the revenue law deprive a taxpayer of the benefit of the capital gains provisions where his property is taken by condemnation proceedings.

> *John J. Bliss*, 27 B. T. A. 813 (1932).
> IT 1378 I-1 C. B. 26 (1922).

Nor has the Board of Tax Appeals failed to give relief under the capital gains provisions of the statute where one dies possessed of installment obligations. The revenue laws provide that installment obligations shall be taken up as matured income at the date of the death of the owner.

> *Provident Trust Co.*, 29 B. T. A. 374.

The Bureau of Internal Revenue has ruled that a mortgagor whose property is foreclosed upon and sold pursuant to legal action taken by the mortgagee must compute his loss on the transaction under the capital gains and loss provisions.

> G. C. M. 12737, XIII-1 C. B. 120 (1934).

The Circuit Court of Appeals in the instant case states (R. 135-136):

> "Between the *redemption* of a bond and the *sale or exchange* thereof, there is a clear distinction. Such redemption is merely the payment of an obligation according to its terms. It is in nowise a sale or exchange. Watson v. Commissioner, 27 B. T. A. 463, 465; Braun v. Commissioner, 29 B. T. A. 1161, 1177."

The reacquisition of bonds by an issuing corporation may be:

(1) By redemption at maturity.

(2) By redemption before maturity pursuant to the terms of the bond.

(3) By purchase in the open market.

It is possible to draw metaphysical distinctions and to argue that in the first case the corporation is simply meeting its obligation when due, while in the second case it is likewise meeting its obligation but accelerating the due date, and in the third case the corporation is buying a piece of property without reference to its obligation to redeem. These distinctions might be of interest if the problem concerned a tax to be paid by the corporation.

But the bondholder occupies a different position. Whether the bondholder exchanges his bonds for cash on the due date or on a date prior to maturity, or sells his bonds in the open market, the result is the same—he has exchanged his bonds for cash—and the only distinction that can be made is that in the first two cases the exchange may be involuntary on the part of the bondholder, while in the third case it is a voluntary exchange.

When the learned Court says "such redemption is merely the payment of an obligation according to its terms," it implies that because there is an obligation to pay the bond it cannot be an exchange. Or to state it differently—because the corporation is obliged to redeem its bonds and does in

fact force the bondholder to accept redemption prior to fixed due date, the bondholder on the other side of the transaction has not "exchanged" his asset. Surely there is nothing to indicate that Congress intended to limit the term "sale or exchange" to transactions where both sides are entirely free in their action

The distinction made by the learned Court is not well founded. "Redemption" is distinguishable from "sale or exchange" but "sale or exchange" includes "redemption." Actually "redemption" is the exchange of bonds for cash. All redemptions are exchanges, but all exchanges are not redemptions. The fact that the redemption does or does not coincide with the maturity of the bond is not important. It still remains the exchange of a bond for cash.

To hold that in such case a redemption is not a "sale or exchange" is to hold an absurdity. It seems unquestionable that Congress would have specifically provided, *as it did in the 1934 and all subsequent Acts,* that "redemption" constituted an exchange, had it not seemed to be perfectly clear on its face. But as was said by this Court in *Burnet v. Guggenheim,* 288 U. S. 280. at 288:

> "This is not to say that meaning has been lost because extraordinary foresight would have made it clearer."

In *Helvering v. Stockholms Enskilda Bank,* 293 U. S. 84. 79 L. Ed. 211 (1934), Mr. Justice Sutherland stated (at p. 218):

> "The intention of the lawmaker controls in the construction of taxing acts as it does in the construction of other statutes, *and that intention is to be ascertained, not by taking the word or clause in question from its setting and viewing it apart, but by considering it in connection with the context, the general purposes of the statute in which it is found, the occasion and circumstances of its use, and other appropriate tests for the ascertainment of the legislative will.* Compare Rein v. Lane, L. R., 2 Q. B. 144, 151. The intention being thus disclosed, it is enough that the word or clause is reasonably susceptible of a

> meaning consonant therewith, whatever might be its meaning in another and different connection." (Italics ours.)

This Court has consistently refused to penalize taxpayers by an overtechnical construction of words. In *Helvering* v. *New York Trust Co.*, 292 U. S. 455, the Commissioner attempted to distinguish (in Sec. 206-a-6 of the Revenue Act of 1921) the holding of property for two years by one taxpayer and the holding for a similar period by a taxpayer and his donee, contending that only in the first instance does the section apply. This Court rejected the distinction, holding it to be arbitrary and unreasonable, and declared at page 467:

> "The legislative purpose to be served by the application of the lower rates upon capital gains is distinctly opposed to the Commissioner's construction. There is no ground for discrimination such as that to which the Trustee was subjected. It is to be inferred that Congress did not intend penalization of that sort."

In expounding its reasoning why such discrimination should not be allowed the Court recited the legislative history of the Act and, after pointing out the discrimination (*supra*), stated at page 464:

> "But the expounding of a statutory provision strictly according to the letter without regard to other parts of the Act and legislative history would often defeat the object intended to be accomplished.
>
> * * * * * *
>
> Quite recently in *Ozawa* v. *United States*, 260 U. S. 178, 67 L. Ed. 199, 43 S. Ct. 65, we said (p. 194): 'It is the duty of this Court to give effect to the intent of Congress. Primarily this intent is ascertained by giving the words their natural significance, but if this leads to an unreasonable result, plainly at variance with the policy of the legislation as a whole, we must examine the matter further. We may then look to the reason of the enactment, and inquire into its antecedent history, and give it effect in accordance

with its design and purpose, sacrificing, if necessary, the literal meaning in order that the purpose may not fail.' "

See:

*Aldridge* v. *Williams*, 3 How. 9, 11 L. Ed. 469 (1845).

*United States* v. *Factors Finance Co.*, 56 F. (2d) 902, aff'd 288 U. S. 89 (1933).

*Hawaii* v. *Mankichi*, 190 U. S. 197, 47 L. Ed. 1016 (1903).

The Ninth Circuit Court of Appeals in the case at bar, after quoting an excerpt from *Burnet* v. *Harmel*, 287 U. S. 103, 106 (R. 136-137), stated:

> "Thus, it appears, the purpose of Congress in relieving the taxpayer from 'excessive tax burdens from gains resulting from a conversion of capital investments' was 'to remove the deterrent effect of those burdens on such conversions.' Conversions on which those burdens had a deterrent effect were sales and exchanges. Such burdens had, and have, no deterrent effect on the redemption of bonds or other capital assets."

The implication of the foregoing is that if the transaction was involuntary it should not benefit by the sale or exchange provision of the law since such transaction was not accelerated by the removal of the "deterrent effect" of an "excessive tax burden."

A reading of the opinion of this Court in *Burnet* v. *Harmel*, *supra*, demonstrates that this Court found Congress to have two purposes in mind, namely, *first, to relieve the taxpayer from excessive tax burdens*, and, *second, to remove the deterrent effect of such excessive tax burdens on the sale or exchange of assets.*

To attribute to Congress as its sole motive, gain in revenue without any relation to fairness to the taxpayer vitiates the entire intent of the legislation. If the only reason for enactment of the capital gain section was the increase in revenue there would have been no point whatsoever in limit-

ing the application of the statute to instances where the assets had been held for more than two years. Gains in revenue would result just as much by encouraging the sale of a capital asset which had been held only temporarily. The two years' limitation was specifically inserted because, as the Supreme Court says, it is inequitable to tax in one year a profit which in fact had accrued over a long series of years.

In *United States* v. *Hartwell*, 6 Wallace 385, at 396, the Court stated:

> "*The proper course in all cases is to adopt that sense of the words which best harmonizes with the context and promotes in the fullest manner the policy and objects of the legislature. The rule of strict construction is not violated by permitting the words of the statute to have their full meaning, or the more extended of two meanings, as the wider, popular instead of the more narrow technical sense; but the words should be taken in such a sense, bent neither one way nor the other, as will best manifest the legislative intent.*" (Italics ours.)

The doubt in the present and similar cases is not caused by the words themselves but by the breadth of the transactions they are intended to cover. In *Brewster* v. *Gage*, 280 U. S. 327, the question before this Court was when a residuary legatee "acquired" property devised for the purpose of capital gain or loss. This Court examined the legislative history of the Act and held that the legatee "acquired" legal title for tax purposes at the time of death, holding that the legislative history did not indicate a purpose to establish different bases for specific and general bequests and that it would be unreasonable to attribute to Congress an intent to have the estate calculate gains and losses on one basis and the residuary legatee calculate his on another.

So, in this case, we submit it is unreasonable to attribute to Congress an intent to differentiate for tax purposes between a man returning bonds to a corporation pursuant to a call for redemption and a man selling the bonds to the corporation without call.

In *Factors Finance Co.* v. *United States*, 56 F. (2d) 902, affirmed 288 U. S. 89 (1933), it was stated at page 908:

> "Statutes must have a reasonable construction, and the language must be interpreted with reference to the subject-matter and the general course of business to which they relate, and in such manner that the beneficent provisions of remedial laws may not be thwarted by nice technicalities not within the minds of the legislators. Lynch v. Alworth-Stephens Co., 267 U. S. 364, 370, 45 S. Ct. 274, 69 L. Ed. 660; Old Colony R. Co. v. Commissioner of Internal Revenue, 52 S. Ct. 211, 76 L. Ed. . . ., decided February 15, 1932."

## D.

**The interpretation of the word "exchange" added to the capital gains section by Congress in 1934 constitutes a legislative declaration of its meaning and governs the construction of the capital gains provision from the time of its first enactment in 1921.**

The decision in *John H. Watson, Jr., supra,* holding that redemption of bonds did not come within the capital gain or loss provisions of the Revenue Act, was promulgated on December 29, 1932, and IT 2678, *supra,* was issued in January or February, 1933. In June, 1933, the Ways and Means Committee commenced the drafting of a new Revenue Act and ordered public hearings held for the purpose of obtaining advice as to changes and clarifications made necessary by decisions in the Income Tax Law.

Mr. George M. Morris, Chairman of the Committee on Federal Taxation of the American Bar Association, by oral argument and by a brief submitted to the Ways and Means Committee, pointed out the conflict between the *Werner* and *Watson* decisions, *supra,* and asked for clarification of the meaning of Congress. On pages 190 and 191 of a publication of the Government Printing Office entitled "Revenue Revision, 1934, Hearing Before the Committee on Ways and Means, House of Representatives, Seventy-Third Congress, Second Session, December 15 to 21, 1933, and January 9 to

11, 1934," appears the written recommendations of the American Bar Association, the portion of which applicable to the problem at the bar being as follows:

"5. Section 101 (c) of the 1932 act defines capital gains and losses as the gains or losses resulting from the 'sale or exchange' of capital assets. The United States Board of Tax Appeals has determined in *Henry P. Werner,* 15 B. T. A. 482, that included within the terms of 'sale or exchange,' was the redemption by the obligor, at or before maturity, of a capital asset. Later the Board held, in *Watson,* 27 B. T. A. 463, that such redemption was not a 'sale or exchange.' *Your committee believes that the Congress did not intend to remove from the benefits of the capital gains and loss provisions gains or losses from the redemption of capital assets, especially when such gains or losses, if the assets had been sold by the holder immediately before redemption, would be considered capital gains or losses.*" (Italics ours.)

"Your committee recommends, therefore, the following resolution and amendment to Section 101 (c) of the 1932 act:

'Be it resolved, that the American Bar Association recommends to the Congress that the Congress redefine the terms "capital gain" and "capital loss" to make clear whether such terms include gains and losses resulting from the redemption at maturity of capital assets, and that the Association's Committee on Federal Taxation is directed to urge the following proposed amendment and, failing the acceptance of the proposal as drafted, its equivalent in purpose, upon the proper committee of the Congress:'

('Proposed Amendment.)

'That Section 101 (c) (1) and (2) be amended to read as follows: "(C) Definitions.—For the purposes of this title—" (1) "Capital gain" means taxable gain from the *sale, exchange or redemption of* capital assets consummated after December 31, 1921.

(2) "Capital loss" means taxable loss resulting from the *sale, exchange or redemption* of capital assets.' "

Section 117 of the Revenue Act of 1934 as enacted contains the following subsection, which puts an end to the controversy:

> "f. Retirement of Bonds, etc.
>
> For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor."

The intent of Congress is perfectly clear. It seems patent that the interpretive words in the statute were designed to accomplish exactly what your petitioner contends, namely, that Congress intended *not to change the law, but to clarify the meaning* in the prior Revenue Acts.

That the Ways and Means Committee and the Senate Finance Committee in their reports omit any reference to paragraph (f) of Section 117 strengthens our contention that the purpose was to clarify and not to amend. Both the Ways and Means Committee and the Senate Finance Committee discuss fully in their reports the drastic alterations made in the capital gains law in the Act of 1934, but do not mention Section 117(f). If either of these committees had thought this subsection was new legislation changing the law, proper parliamentary procedure would have required them to state in their reports the reason why they recommended such change.

In *Mead Corporation*, 38 B. T. A. #93, promulgated September 30, 1938, the Board of Tax Appeals, in discussing the significance of the omission of language in committee reports concerning the meaning of an amendment to Section 102 of the Act, stated at page 18:

> "It has been suggested that the amendment included in the 1934 Act, which put the question we are considering beyond any possible doubt, is evidence that Congress believed a change to be necessary, and there-

fore that the section had meant something different previously. Without considering the effect of the decision by one Congress as to the meaning of legislation enacted by another, *it is sufficient to say here that there is no evidence that the change in language so made was anything more than clarification, or that there was any intention to enact a new or different provision. Although the Ways and Means Committee Report 'pointed out' the application of the section to the 'shareholders of a parent corporation,' it referred to 'two important changes' it proposed, neither of which is the altered language significant here. The Senate Finance Committee Report contains no mention of this altered language which was added by the House, but states only that 'The House bill changes the existing law in two respects' (those discussed in the House Report) indicating that the Senate likewise did not view the language here in question as changing the existing law. There had been some question raised as to the meaning of the section, and under such circumstances a desire for clarification is easily conceivable.* We are not required thereby to assume that any change of the previous law was intended. 'Mere change of language does not necessarily indicate intention to change the law. The purpose of the variation may be to clarify what was doubtful and so to safeguard against misapprehension as to existing law.' *Helvering v. New York Trust Co., supra.*" (Italics ours.)

It is noteworthy that the words "sale or exchange" were retained and the meaning of "exchange" explained in a subsection. Had Congress intended to change the law, it is submitted that the change would have been made by adding the word "redemption" or some similar word to the words "sale or exchange."

It being the intention of Congress to interpret rather than to amend, the rule laid down by Chief Justice Marshall in *Alexander v. The Mayor, &c. of Alexandria*, 5 Cranch. 1 (1809), applies. By virtue of this opinion it has become a settled law of statutory construction that when doubt arises as to a meaning of a statute and the Legislature which enacted the same, by subsequent re-enactment, adds words by way of explanation or amplification of the disputed phrase, such additional words are deemed to evidence the intent of

the legislative body in passing the original act. As Chief Justice Marshall stated:

> "Without deciding this question as depending merely on the original law, it is to be observed that acts *in pari materia* are to be construed together as forming one act. If in a subsequent clause of the same act provisions are introduced which show the sense in which the legislature employed doubtful phrases previously used, that sense is to be adopted in construing those phrases. Consequently, if a subsequent act on the same subject affords complete demonstration of the legislative sense of its own language, the rule which has been stated, requiring that the subsequent should be incorporated into the foregoing act, is a direction to courts in expounding the provisions of the law."

The rule is again succinctly stated in 25 Ruling Case Law, 1064, at Section 288, which reads:

> "If in a subsequent clause of the same act provisions are introduced which show the sense in which the legislature employed doubtful phrases previously used, that sense is to be adopted in construing those phrases. Consequently, *if a subsequent act on the same subject affords complete demonstration of the legislative sense of its own language, the rule which has been stated, requiring that the subsequent should be incorporated into the foregoing act, is a direction to courts in expounding the provisions of the law.* An amendment to an act may be resorted to for the discovery of the legislative intention in the enactment amended." (Italics ours.)

See also:

- *Panther Rubber Co.* v. *Commissioner,* 45 Fed. (2d) 314 (1930).
- *Old Colony Trust Co.* v. *Malley,* 19 Fed. (2d) 346; cert. denied 275 U. S. 563 (1927).
- *Joy Floral Co.* v. *Commissioner,* 29 Fed. (2d) 865 (1928).
- *Merle-Smith* v. *Commissioner,* 42 Fed. (2d) 837 (1930).
- *McCauley* v. *Commissioner,* 44 Fed. (2d) 919 (1930).

*Greensboro Gas Co.*, 30 B. T. A. 1361, aff'd 79 Fed. (2d) 701 (1935).

*Davidson Grocery Co.* v. *Lucas*, 37 Fed. (2d) 806 (1930).

*Johnston* v. *Commissioner*, 86 Fed. (2d) 732; cert. denied 301 U. S. 683 (1937).

*W. A. Sheaffer Pen Co.* v. *Lucas*, 41 Fed. (2d) 117 (1930).

*Jordan* v. *Roche*, 228 U. S. 436, 57 L. Ed. 908 (1913).

*Helvering* v. *New York Trust Co., supra.*

*Jordan* v. *Roche, supra,* and *Helvering* v. *New York Trust Co., supra,* clearly demonstrate the readiness of this Court to construe a subsequent addition as a clarification of existing law, when, as in this case, it is clear that Congress intended to correct inequitable and absurd results occasioned by judicial construction.

In *Jordan* v. *Roche,* this Court had for decision the question of whether or not bay rum imported from Porto Rico during 1907 and 1908 was subject to tax under the Foraker Act of 1900 (Chap. 191, 31 Stat. 77) which taxed the importation of "distilled spirit, spirits, alcohol and alcohol spirit." The plaintiffs contended that the amendment of the Act in 1909 to raise the tax specifically on bay rum imported from Porto Rico indicated that bay rum was not taxed by the prior Act. The Court denied this conclusion and held that bay rum was taxed by the Foraker Act, stating:

> "One other contention of plaintiffs we may notice. On February 4, 1909, 35 Stat. 594, c. 65, Congress passed the act by which it is provided 'that upon bay rum, or any article containing alcohol, hereafter brought from Port Rico into the United States for consumption or sale there shall be paid a tax on the spirits contained therein of one dollar and ten cents per proof gallon,' and the Commissioner of Internal Revenue is given power to establish rules to make the act effective. It is insisted that this act is a declaration by Congress that bay rum was not subject to a tax under prior statutes. The history of the act rejects the contention and manifests that the act was passed in consequence

> of the decision in *Newhall* v. *Anderson*, and the other decisions to which we have referred. *The law was not the declaration of a new policy but a more explicit expression of the purpose of the prior law, made necessary by the judicial construction of that law.*" (Italics ours.)

*Helvering* v. *New York Trust Co., supra*, is a particularly strong authority for the interpretation claimed in the present case. There the statute in issue was Section 206-a-6 of the Revenue Act of 1921, which defines "capital assets" to be "property acquired and held by the taxpayer * * * for more than two years." The question in issue was whether the words "held by the taxpayer * * * for more than two years" allowed the tacking together of the tenure of a donor and trustee of a trust, so as to extend the capital gain tax rate to profits realized by the trustee from the sale of capital assets within two years from the date of the creation of the trust. The Commissioner pointed out the fact that long-continued rulings of the Income Tax Unit of the Bureau of the Bureau of Internal Revenue and the courts were against the trustee's contention. It was pointed out that the Revenue Act of 1926, Section 208-a-8, contained a rule for determining the period for which a taxpayer has held capital assets, substantially similar to the construction for which the trustee contended, and that said change constituted new law. The Court examined the intent of Congress in passing the legislation and ruled that its remedial nature entitled the trustee to tack tenures. In respect of the additions to the statute made by the Revenue Act of 1926, the Court stated:

> "Mere change of language does not necessarily indicate intention to change the law. The purpose of the variation may be to clarify what was doubtful and so to safeguard against misapprehension as to existing law. In view of the inclusion of the same definition in the Acts of 1921, 1924 and 1926 and the legislative purpose underlying it, the contention that the new words were added to change the meaning of 'capital assets' as defined in the earlier acts is without force. *The definition so clarified was not new law but 'a more explicit expression of the purpose of the prior law.' Jordan* v. *Roche*, 228 U. S. 436, 445, 57 L. Ed. 908, 911, 33 S. Ct. 573." (Italics ours.)

In *Sherman & Bryan* v. *Blair,* 35 Fed. (2d) 713 (C. C. A. 2d, 1929), the taxpayer attempted to charge off a portion of a bad debt under Section 234(a) of the Revenue Act of 1918 (40 Stat. 1077), which provided:

> "(5) Debts ascertained to be worthless and charged off within the tax year."

The Commissioner argued that the above section only permitted the charge-off of a debt *entirely worthless* and cited in support of that contention the fact that the Revenue Act of 1921, 42 Stat. 255, Section 234-a-5 provided as follows:

> "(5) Debts ascertained to be worthless and charged off within the taxable year and when satisfied that a debt is recoverable only in part the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction."

This, he argued, constituted new law which was not retroactive. The Court permitted the partial charge-off of the debt, stating:

> "But such subsequent legislation is not conclusive that the construction claimed for the earlier act must be accepted. See Russell v. United States, 278 U. S. 181, 188, 49 S. Ct. 121, 73 L. Ed. 255. 'Debts ascertained to be worthless' might, it would seem, reasonably be construed to mean 'indebtedness ascertained to be worthless,' and to permit a charge-off of such part of a claim as was proven to be uncollectible by so definite an event as seizure of the debtor's property by a receiver."

See also *Davidson Grocery Co.* v. *Lucas*, 37 Fed. (2d) 806 (Ct. App., D. C., 1930).

Petitioner respectfully submits that the Circuit Court of Appeals for the Ninth Circuit completely misconstrued the intent of Congress in amending the capital gains statute, and that, as held by the First Circuit Court of Appeals in *Averill* v. *Commissioner* (Appendix D), it constituted a more explicit declaration of the purpose and intent of the capital gains provisions from 1921 to date.

## CONCLUSION.

1. The surrender by the taxpayer of bonds of the Elton Corporation for redemption during the years 1927, 1928 and 1929 was an exchange or sale of capital assets within the meaning of the provisions of the Revenue Acts of 1926 and 1928, and the excess of the sum received by the taxpayer over and above cost basis to the taxpayer was capital gain within the meaning of the Revenue Acts of 1926 and 1928 and was taxable to him at the flat rate of 12½% instead of at the higher rates (normal and surtaxes).

2. The judgment of the Circuit Court of Appeals for the Ninth Circuit and the judgment of the District Court for the Southern District of California, Central Division, should be reversed and the complaint dismissed.

Respectfully submitted,

ARTHUR F. DRISCOLL,
Counsel for Petitioner.

## APPENDIX A.

I. T. 1637, appearing at II-1 C. B. 36, provides:

"REVENUE ACT OF 1921.

Non-interest-bearing obligations of a political subdivision of a State were issued at 88 and upon maturity in the latter part of 1923 a taxable profit of 6 x will be realized by the holder not the original purchaser. Inasmuch as the obligations have been held for over two years inquiry is made whether the taxpayer will be subject to a tax on the capital net gain derived therefrom at the rate of 12½ per cent."

Section 206 of the Revenue Act of 1921, reads, in part, as follows:

"(a) That for the purpose of this title:

(1) The term 'capital gain' means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921.

When an obligation matures it is neither sold nor exchanged. Any taxable profit derived upon maturity of a non-interest-bearing obligation is, therefore, not 'capital gain' derived from the sale or exchange of capital assets and section 206 does not apply."

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## APPENDIX B.

I. T. 2488, reported in VIII-2 C. B. 127, provides as follows:

"REVENUE ACTS OF 1921, 1924, 1926 AND 1928.

The net gain from bonds held for more than two years, whether received as the result of the maturity of the bonds or as the result of their redemption before maturity, may, at the option of a taxpayer other than a corporation, be taxed as a capital net gain under the provisions of section 206 of the Revenue Act of 1921. I. T. 1637 (C. B. II-1, 36) revoked.

Likewise, any individual who has held stock in a corporation for more than two years and who derives

a gain when the stock is 'called in' may elect to have such gain taxed as a capital net gain in the manner and subject to the conditions prescribed in section 206 of the Revenue Act of 1921.

The foregoing ruling is also applicable under the Revenue Acts of 1924, 1926 and 1928.

---

A ruling is requested as to the manner in which the gain from bonds or stock held for more than two years should be treated where the bonds are redeemed before their maturity date or the stock is 'called in.'

Under the provisions of section 206 of the Revenue Act of 1921, any taxpayer (other than a corporation) who for any taxable year derives a capital net gain may elect to be taxed on such capital net gain at the rate of 12½ per cent. in lieu of the tax he would otherwise pay on such income under sections 210 and 211. Section 206 of the Revenue Act of 1921 reads, in part, as follows:

> (a) That for the purpose of this title:
>
> (1) The term 'capital gain' means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921.

In I. T. 1637 it was held that when an obligation matures it is neither sold nor exchanged. It was further held that any taxable profit derived upon maturity of an obligation is therefore not 'capital gain' derived from the sale or exchange of capital assets and section 206 does not apply.

Under date of February 19, 1929, the United States Board of Tax Appeals decided, in the case of Henry P. Werner (15 B. T. A. 482, see on page 56), that the redemption of bonds at a 'called' date for an amount in excess of the cost of the bonds to the bondholder results in a gain from the sale or exchange of capital assets within the meaning of section 206 of the Revenue Act of 1921. In the decision the legislative history of section 206 of the Revenue Act of 1921 was reviewed. It was stated that the Ways and Means Committee of the House and the Finance Committee of the Senate declared that the provision was intended to be applicable to the 'sale or other disposition of capital assets.'

The ruling contained in I. T. 1637 is hereby revoked. The net gain from bonds held for more than two years, whether received as the result of the maturity of the bonds or as the result of their redemption before maturity, may, at the option of a taxpayer other than a corporation, be taxed under the provisions of section 206 of the Revenue Act of 1921.

Likewise, any individual who has held stock in a corporation for more than two years and who derived a gain when the stock is 'called in' may elect to have such gain taxed as a capital net gain in the manner and subject to the conditions prescribed in section 206 of the Revenue Act of 1921.

As the provisions of the Revenue Acts of 1924, 1926 and 1928 relating to capital net gains are similar to the provisions of section 206(a)(1) of the Revenue Act of 1921, the foregoing ruling is also applicable under those Acts."

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## APPENDIX C.

I. T. 2678, appearing in XII-1 C. B. 117, is as follows:

"Revenue Acts of 1921, 1924, 1926 and 1928.

I. T. 2488 (C. B. VIII-2, 127), which holds that the gain derived from stock of a corporation 'called in,' or the gain derived from bonds as the result of their maturity or redemption before maturity, where such stock or bonds have been held for more than two years, may be taxed as a capital net gain, is revoked, in so far as inconsistent with the decision of the Board of Tax Appeals in *John H. Watson, Jr. v. Commissioner* (27 B. T. A. 463, page 13, this Bulletin)."

## APPENDIX D.

## UNITED STATES CIRCUIT COURT OF APPEALS

FOR THE FIRST CIRCUIT

OCTOBER TERM, 1938.

FRANCES M. AVERILL,
*Petitioner for Review,*
v.
COMMISSIONER OF INTERNAL REVENUE.

No. 3376.

PETITION FOR REVIEW OF A DECISION OF THE UNITED STATE
BOARD OF TAX APPEALS.

BEFORE BINGHAM, WILSON AND MCLELLAN, JJ.

### Opinion of the Court.

December 28, 1938.

MCLELLAN, J. This petition to review a decision of th
Board of Tax Appeals presents the question whether the gai
realized by the petitioner when bonds owned by her were pai
at maturity in 1931 should be taxed as ordinary income. Th
Board decided that such gain should be taxed as ordinary in
come; the petitioner urges that it should be taxed as capita
gain at the maximum rate of 12½ per cent. The Board err
and the petitioner should prevail:

1. If a transaction in 1927 in which she parted with som
stock and received cash and bonds was a sale for a price pa
able by installments and not as to her a statutory reorganiza
tion; or

2. If, though the 1927 transaction was not a sale, the 193
surrender of her bonds then maturing for which she receive
payment was a "sale or exchange" within the meaning of th
Revenue Act of 1928.

The reason the petitioner should prevail if she sold her stock in 1927 is that the rights of the parties would then be governed by a statute permitting the taxpayer who sells or otherwise disposes of property on the installment plan to return as income in any taxable year that portion of the installment payments actually received in that year which the total profit realized or to be realized when the payment is completed bears to the total contract price (Revenue Act of 1926, Section 212(d) ), and by a statute giving the taxpayer in case of a capital net gain an election to pay a 12½ per cent tax thereon (Revenue Act of 1928, Section 101(a) ). The reason the petitioner should prevail if the transaction by which she gave up her bonds and received payment therefor in 1931 constituted a sale or exchange of the bonds is that in such a case the statute last cited gives the taxpayer an option to pay a 12½ per cent tax on a capital gain, which Section 101(c) of the Revenue Act of 1928 defines as "a taxable gain from the sale or exchange of capital assets."

We proceed to state the facts material to these two questions.

For more than two years prior to January 1, 1927, the petitioner had owned 1500 shares of the common stock of Keyes Fiber Company, hereafter sometimes called the old company. This corporation at all times here material had outstanding but one issue of stock—its common stock, of which there were 6000 shares.

On July 27, 1927, the petitioner, her husband George S. Averill and other shareholders representing in all 5912 shares, entered into a contract with the Rex Pulp Products Company, hereinafter called Rex. In this contract the shareholders of the old company, referred to therein as "the vendors," agreed to "sell, assign and convey all the shares owned by them to a new corporation to be organized under the laws of Maine, hereinafter known as the vendee, to be called Keyes Fiber Company, Inc., or some similar name, at the agreed purchase price of seven hundred fifty (750) dollars per share." Rex agreed "that it will cause the vendee to pay to each of said vendors on or before the 11th day of August, 1927, at the Fidelity Trust Company, Portland, Maine, for the num-

ber of shares of stock in said company which said vendors shall properly deliver to the order of the vendee at the Fidelity Trust Company, Portland, Maine, the sum of seven hundred fifty (750) dollars per share." Rex also agreed that "such payments shall be made as follows, viz: 5/9 (five ninths) of the purchase price for said shares shall be paid in the first mortgage bonds of the vendee and the remaining 4/9 (four ninths) of such price shall be paid in cash." It was further agreed that the proportion of bonds and cash paid to the individual vendors should be as agreed upon among themselves. The contract provided in substance that the first mortgage bonds should constitute a first lien on all the property "now or hereafter acquired" by either the old company, or Rex, or the corporation to be organized.

Later, Keyes Fiber Company, Inc., hereafter sometimes called the new company, was organized. On August 11, 1927, certain corporate votes were passed by the old Company, Rex, and the new company. The new company first acquired all the assets of Rex in exchange for its own common stock. It then assumed those obligations which the contract of July 27 provided that it should assume, and voted to purchase the 5912 shares of the old company as provided in the contract. The stock of the old company was then assigned to the new company, which immediately pledged it to a trustee as security for the performance of its obligations under the contract. The old company then conveyed all its assets to the new company for the agreed price of $4,500,000, and this sum was paid to it by the new company, 4/9s in cash and 5/9ths in bonds. The old company then made a liquidating dividend to its stockholders of $750 a share, 4/9ths in cash and 5/9ths in bonds, and was later dissolved. This dividend was received by the new company as holder of the stock of the old company, and was immediately transferred to the former stockholders of the old company in exchange for their stock, in accordance with the terms of the contract of July 27 and of the pledge to the trustee. While, as heretofore stated, the contract of July 27, 1927 provided that the purchase price of the stock should be paid 5/9ths in bonds of the vendee and 4/9s in cash, there was a provision that "the proportion of

payment of bonds and cash should be such as is agreed upon among said vendors." Accordingly, the petitioner received $275,000 cash, which was just less than 25 per cent of the purchase price, and $850,000 in serial bonds which were of the par value of $1,000 cash and worth par when received in 1927. One tenth of the petitioner's 850 bonds matured in each of the years 1931 to 1936 inclusive and four tenths in 1937.

At all material times up to August 11, 1927, the date on which the petitioner disposed of her stock in the old company, her husband, Dr. George G. Averill, was a large stockholder, a director, treasurer and clerk of the old company. The petitioner held no office in the old company. Neither Dr. nor Mrs. Averill held any office in Rex Pulp Products Company or the new company at any time, nor did either of them hold any office in the old company at any time after the petitioner disposed of her stock. Thus it appears that so far as the petitioner is concerned all she did was to transfer her stock in the old company for cash and serial bonds of the transferee.

As heretofore indicated, the first question is whether the transaction in 1927 was tantamount to a sale by the taxpayer of her corporate stock for a price to be paid in installments.

The Board decided and the Commissioner contends that it was not a sale but an exchange by a party to a reorganization of stock in a corporation for securities in another corporation in pursuance of the plan of reorganization. Some of the essentials of a statutory reorganization inhered in what was done in 1927. These we think it unnecessary to discuss in detail. That the corporate bonds may be deemed "securities" within the meaning of the reorganization provisions of the statute is settled by *Helvering* v. *Watts*, 296 U. S. 387, where the Supreme Court said: "The bonds, we think, were securities within the definition, and cannot be regarded as cash, as were the short term notes referred to in *Pinellas Ice and Cold Storage Company* v. *Commissioner*, 287 U. S. 462." The decision that the bonds there involved "were securities within the definition, and cannot be regarded as cash" is referable to

a contract where no sale but only an exchange for stock and bonds was intended. An inspection of the contract in that case, appearing in 28 B. T. A. 1056, shows that the parties contemplated no sale, but only an exchange of stock for stock and bonds. Consistent with the rest of the contract are the clauses reading:

> "Whereas, said Parker Sloane is exchanging and delivering to and with the Vanadium Corporation of America Thirty Thousand (30,000) shares of the stock of the United States Ferro Alloys Corporation, * * * and
>
> "Whereas, the Vanadium Corporation of America is exchanging and delivering to said Parker Sloane, Trustee for the owners of said United States Ferro Alloys Corporation" (certain shares of stock together with certain bonds).

We understand the Watts case as holding that bonds may be deemed securities, and that if treated as such, they cannot be regarded as cash. It does not indicate that where, as in the case at bar, a person expresses his intention to sell and another to buy corporate stock and both parties contemplate a sale for a price payable by installments, that the transaction loses its character as such just because the vendee's obligation is represented in part by serial bonds. Neither does the Watts case nor, so far as we know, any other decision of the Supreme Court of the United States, decide that the ownership of bonds without stock ever constitutes such a continuing interest as is essential to a statutory reorganization, a question which we are not called upon to decide. *Cf. Worcester Salt Company* v. *Commissioner*, 75 Fed. (2d) 251 (C. C. A. 2d) and *Lilienthal* v. *Commissioner*, 80 Fed. (2d) 411 (C. C. A. 9th).

The instant case discloses that the taxpayer contracted to sell her stock at $750 a share and the new corporation undertook to buy it at that price. The total price was to be paid, as to about 25 per cent thereof, in cash and the balance over a period of years. The petitioner's husband then relinquished

his connections with the old company and had nothing to do with the management of the new one. Both intended to get out of the business and the new company intended that they should. The substance of the transaction was a sale by installments and the serial bonds were treated merely as a convenient method of providing for the installment payments. We see no adequate reason for saying that the intention of the parties should not be given effect. As to the taxpayer, the transaction amounted to a sale of her stock, not an exchange "by a party to a reorganization of stock in a corporation for securities in another corporation, a party to the reorganization, in pursuance of the plan of reorganization."

As before stated the taxpayer sold her stock in 1927 for a price payable in installments. Within the meaning of the statute she did not exchange it for securities in another corporation. The sale was casual, the purchase price exceeded $1,000 and the initial payment received in cash other than evidences of indebtedness of the purchaser during the year in which the sale was made and did not exceed one-quarter of the purchase price. In short, the transaction was within Section 212 of the Revenue Act of 1926, which permits the return in any taxable year of "that proportion of the installment payments actually received in that year which the total profit realized or to be realized when the payment is completed bears to the whole contract price."

In her tax return for 1927 the petitioner reported gains from the disposition of her stock upon the installment basis and upon that basis her income tax for that year was paid. The Commissioner made no adjustment of the tax as to the petitioner, though he "disallowed the use of the installment basis as to Dr. George G. Averill and computed the gain under the reorganization exchange provisions." In the position then taken by the taxpayer she was right. Collection of the serial bonds falling due in 1931, with which we are here concerned, involved a net gain which, by virtue of Section 101 of the Revenue Act of 1928, is taxable at 12½ per cent.

We now come to a different question. If the 1927 transaction were governed by the statutory reorganization provisions, it would not follow necessarily that the Board's de-

cision is correct. When in 1931 the taxpayer surrendered her bonds then maturing and received payment therefor, she realized a gain over their stipulated cost. Her right to treat this profit as a capital gain taxable at the rate of 12½ per cent depends upon the portions of the Revenue Act of 1928 which follows:

> SEC. 101. CAPITAL NET GAINS AND LOSSES.
>
> (a) Tax in case of capital net gain.—In the case of any taxpayer, other than a corporation, who for any taxable year derives a capital net gain (as hereinafter defined in this section), there shall, at the election of the taxpayer, be levied, collected, and paid, in lieu of all other taxes imposed by this title, a tax determined as follows: a partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner as if this section had not been enacted and the total tax shall be this amount plus 12½ per centum of the capital net gain.
>
> (c) Definitions.—For the purposes of this title—
>
> (1) "Capital gain" means taxable gain from the sale or exchange of capital assets.
>
> * * * * * *
>
> (7) "Ordinary net income" means the net income, computed in accordance with the provisions of this title, after excluding all items of capital gain, capital loss, and capital deductions.
>
> (8) "Capital assets" means property held by the taxpayer for more than two years * * *

At the outset we are confronted with the question whether it is so clear that the words "taxable gain from the sale or exchange of capital assets" do not include a transaction whereby bonds are redeemed at maturity that we are not permitted to use the canons of interpretation commonly used where the question is fairly debatable. If it were true that in the very nature of things a covenantee cannot sell a bond or

other specialty to the covenantor, this would tend to support the Board's decision. But we think the holder can sell the bond to anybody. The incidents of such sales vary. If the bond is sold to a stranger, he gets it and with it the right to enforce it. If an attempted sale is made to the covenantor, he gets the bond though he acquires no right to enforce it. Perhaps one way to put it is that in either case there is a sale or transfer of title for a price—that in one case the subject matter of the sale is the bond as a valid obligation, and that in the other case the subject matter of the sale is the bond as something calculated no longer to represent contractual rights. It makes no difference whether the transaction is regarded as the sale of a contract right to a stranger or as a sale of a "piece of paper" to the covenantor. In either case the original holder may be regarded as having realized a gain from the sale of a specialty.

In prior decisions and in the case at bar the Board adheres to the view that preferred stock may be sold to the corporation which issued it. *Helvering* v. *Schoellkopf*, recently decided by the Second Circuit and not yet reported, indicates that within the meaning of the reorganization statute a corporation's own shares cannot be regarded as "property acquired" by it. But we find nothing there requiring the conclusion that a bond, particularly in a state where the distinction between sealed and unsealed instruments has not been abolished, cannot be sold to its maker.

Moreover, a transaction whereby a holder surrenders his bond and receives payment thereof or therefor has commonly been called a redemption, which derivatively and according to the dictionaries, and Judge Wilson's opinion while Chief Justice of the Maine Supreme Court, is a repurchase. *Bernstein* v. *Blumenthal*, 127 Me. 393, 396.

We think the proper construction of the words "taxable gain from the sale or exchange of capital assets" sufficiently debatable to warrant a brief reference to the history of this clause of the statute.

The first legislation according special treatment to capital gains is in the Revenue Act of 1921. There the definition of capital gain as "taxable gain from the sale or exchange of

capital assets" first appeared. It reappeared in the intervening Acts and that of 1932. Referring to the purpose of the Congress in passing the Revenue Act of 1921, the Supreme Court of the United States in *Burnet* v. *Harmel*, 287 U. S. 103, 106, said:

> "* * * The provisions of the 1921 Revenue Act for taxing capital gains at a lower rate, re-enacted in 1924 without material change, were adopted to relieve the taxpayer from these excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions."

Prior to the Revenue Act of 1928, here applicable, the practice had been to treat gains incident to the redemption of bonds as ordinary income. The tendency of the use of the same language in the 1928 Act was to indicate a congressional intent to the same effect. But after the 1928 Act was passed there was a series of events pointing another way.

In *Werner* v. *Commissioner*, 15 B. T. A. 482, the Board of Tax Appeals in 1929 recited the legislative history of the statutory definition now under consideration and concluded that the redemption of "called" bonds constituted a "sale or exchange." It may be stated parenthetically that no importance was attributed to the fact that the bonds were "called" and we do not see how that fact is of consequence. After this decision by the Board, the Commissioner in IT :2488 (2 C. B. 127) revoked his previous ruling and directed that the net gains from bonds held for more than two years received as a result of the maturity of the bonds or as a result of their redemption before maturity may, at the option of the taxpayer, other than a corporation, be taxed under the capital gains section of the Revenue Act of 1921. This ruling was also made applicable to the Revenue Acts of 1924, 1926, and 1928. As stated in the petitioner's brief, "thus, from 1929 until December 1932, the ruling of the administrative department of the Government in charge of the collection of income taxes, as well as the ruling of the Board, interpreted the statute in accord with the petitioner's contention." In the

light of this interpretation, Congress in 1932 reenacted its definition of "capital gain" in precisely the same language. Unless the Werner case was plainly erroneous, and we do not think it was, this reenactment of the statute might well be considered as a satisfactory interpretation of the legislative intent. *Buttolph* v. *Commissioner,* 29 Fed. (2d) 695 (C. C. A. 7th, 1928). See also *Hassett* v. *Welch,* 303 U. S. 303.

On December 29, 1932, the Board of Tax Appeals reversed the Werner decision (*Watson* v. *Commissioner,* 27 B. T. A. 463). Thereafter, as shown in a publication of the Government Printing Office entitled "Revenue Revision, 1934, Hearing before the Committee on Ways and Means, House of Representatives, 73d Congress, Second Session, December 15 to 21, 1933 and January 9 to 11, 1934," the American Bar Association recommended that the Congress re-define the terms "capital gain" and "capital loss" to make clear whether such terms include gains and losses resulting from the redemption at maturity of capital assets. In the Revenue Act of 1934 it was provided:

> SEC. 117. CAPITAL GAINS AND LOSSES.
>
> (a) General Rule.—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income: (there follows a statement as to the percentages).

In subdivision (f) of the same section it was provided that "for the purposes of this title, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation * * * shall be considered as amounts received in exchange therefor."

There seem to us two admissible views as to the bearing of this legislation, one that it constitutes a legislative declaration of the meaning of the word "exchange" and governs the construction of the word in prior Acts, the other the view

expressed by the Circuit Court of Appeals for the 9th Circuit in the following language:

> "When Congress determined, as it did in 1934, to treat as 'capital gains' gains resulting from the retirement of bonds issued by a government or corporation, it had no difficulty in expressing its intent in clear and unambiguous language. Revenue Act of 1934, Sec. 117 (f), 48 Stat. 715, 26 U. S. C. A. Sec. 101 (f). If such intent had existed prior to 1934, it could and, we think, would have found similar expression."
>
> *United States* v. *Fairbanks,* 95 Fed. (2d) 794, 796.

Though the question seems to us a close one, we think under all the circumstances that the doctrine enunciated by Chief Justice Marshall in *Alexander* v. *The Mayor of Alexandria,* 5 Cranch 1, is here relevant. He there said:

> "Without deciding this question as depending merely on the original law, it is to be observed that acts *in pari materia* are to be construed together as forming one act. If in a subsequent clause of the same act provisions are introduced, which show the sense in which the legislature employed doubtful phrases previously used, that sense is to be adopted in construing those phrases. Consequently, if a subsequent act on the same subject affords complete demonstration of the legislative sense of its own language the rule which has been stated, requiring that the subsequent should be incorporated into the foregoing act, is a direction to courts in expounding the provisions of the law."

This language is quoted in full in this court's opinion in *Panther Rubber Co.* v. *Commissioner,* 45 Fed. (2) 314, where Judge Wilson also said:

> "Congress, by substitute provisions, *in pari materia* with section 250 of the Revenue Act of 1921, has indicated that such was its intent, and has made it clear in the act of 1924 and especially in the Revenue Act of

1928. In the Revenue Act of 1924, Sec. 278 (c), Congress provided that assessment and collection may be had after the expiration of the statutory period, where the taxpayer and commissioner, 'have consented,' indicating a past act. This might not be conclusive, but Congress in the Revenue Act of 1928 clearly indicated its intent (see chapter 852, Sec. 276 (26 U. S. C. A. Sec. 2276)), and required the waiver to be signed before the limitation period for assessing the tax expired."

See also:

*Old Colony Trust Company* v. *Malley*, 19 Fed. (2d) 346.

We think the taxpayer's 1931 gain not taxable as ordinary income, but as capital gain at the maximum rate of 12½ per cent because the 1927 transaction was a sale for a price payable in installments not affected by the reorganization provisions of the statute, and because, if this is not so, the redemption of her bonds in 1931 resulted in a "capital gain" within the meaning of the statutory definition of that term.

*The decision or order of the Board of Tax Appeals is reversed and the case is remanded to that Board for further proceedings not inconsistent with this opinion.*